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A Note On Retrospectively Rated Insurance and Federal Income Taxation

By DONALD ARTHUR WINSLOW*

When contracting for a typical insurance policy, the insured normally knows the amount that must be paid to the insurance company regardless of the amount of the losses experienced under the policy.¹ But insurance is not so simple for a large business because it is exposed to numerous risks. In such a case, the amount of potential losses can become so great that either the insured or a potential insurer can state with reasonable certainty that a fair number of risks will mature into losses.² Any premium charged by an insurance company must be sufficient to cover the losses expected or likely to occur plus other charges and an amount for profit. Similarly, because the expected losses will be predictable within a relatively narrow range, neither the would-be insured nor the insurer should be willing to pay much more or receive much less in premium payments than the losses expected to occur; the would-be insured likely would not insure the business' risks rather than pay too high a premium.³ Moreover, the two parties might

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¹ A. WILLETT, *THE ECONOMIC THEORY OF RISK AND INSURANCE* 89 (1951); M. FRIEDMAN, *PRICE THEORY* 80-81 (1976).

² A. WILLETT, *supra* note 1, at 72-75.

³ See *id.* at 75-76; R. GOSHAY, *CORPORATE SELF-INSURANCE AND RISK RETENTION PLANS* 42 (1964); H. SNIDER, *Risk Management and General Insurance Problems*, in *RISK MANAGEMENT* 123, 134 (H.W. Snider ed. 1964).

have opposing expectations regarding the range of expected losses.

Retrospectively rated insurance offers the possibility of bringing these parties together⁴ through flexible premium amounts, where neither party faces unacceptable choices. The insurance company is not faced with likely and burdensome losses and the insured does not face the prospect of grossly overpaying for the coverage that it needs.

Because the insured will pay an amount that corresponds somewhat with its losses, retrospectively rated insurance can be compared to cash flow plans that do not involve a third party insurance company. For example, self-insurance⁵ and captive insurance⁶ are designed to arrange for the payment of liabilities that will mature from the risks of a business, while retaining the use of the funds that would otherwise be used to pay a premium to an insurance company.⁷ The tax goal of these plans is to achieve a federal income tax⁸ deduction for the losses or premiums. These cash flow plans have been the subject of substantial debate among commentators, courts and occasionally Congress, with results in cases and statutes generally disallowing a deduction for the liability or premium in question.⁹ Retrospectively rated plans work similarly since the in-

⁴ See R. GOSHAY, *supra* note 3, at 42; *Risk Management and General Insurance Problems*, *supra* note 3, at 134.

⁵ Under a self-insurance plan, "[a]mounts that might otherwise be paid as a premium to an insurance company remain under the control of the business, where they can continue to produce a return for the business until the losses are paid." Bradley & Winslow, *Self-Insurance Plans and Captive Insurance Companies—A Perspective on Recent Tax Developments*, 4 AM. J. TAX POL'Y 217, 218 (1985).

⁶ "Captive insurance companies are designed to secure the benefits of tax deferral through the creation and use of a subsidiary insurance or reinsurance corporation." *Id.*

⁷ See generally *id.* at 217-19.

⁸ References to I.R.C. sections are to the current version of the Internal Revenue Code of 1986 unless otherwise specified. References to Treasury Regulations are to the regulations currently in force, unless otherwise specified.

⁹ Captives have generated a still growing body of authorities. Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79, 81 n.8 (1989). The courts generally have denied the deduction for single parent corporations paying premiums to captives. See, e.g., *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987), *aff'g*, 84 T.C. 948 (1985); *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. 1986); *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981), *aff'g*, 71 T.C. 400 (1978); *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985). Occasional cases have allowed deduction of captive premium expense based on unusual facts. See, e.g., *Humana Inc. v. Commissioner*, 88 T.C. 197 (1987), *aff'd in part and rev'd in part*, 881 F.2d 247 (6th Cir. 1989) (brother-sister corporations can shift and distribute risk); *Crawford Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985) (captive owned by several parties); *Gulf Oil Corp. v. Commissioner*, 89 T.C. 1010 (1987) (a

sured pays an amount that corresponds to its losses and the premium payment may be delayed to approximate loss payments. In the retro context, the insured deducts as a business expense an amount equal to the insurance premium.¹⁰ These plans present tax issues similar to those found in the other cash flow plans, such as self-insurance and captives.¹¹ Thus, they possess similar potential for conflict between taxpayers and the government.

Retrospectively rated insurance arrangements are the primary means by which a commercial insurer can give the insured a portion of the cash flow advantages of the self-insurance and captive arrangements.¹² The retro arrangement predominates as the insurance vehicle used by sizeable businesses.¹³ Yet it is seldom mentioned in the trade magazines¹⁴ or in the legal literature.¹⁵

wholly owned captive that insures unrelated third party risks may, at some point, meet the risk shifting and risk distribution standard) (dicta *aff'd in part and rev'd in part*, 90-2 U.S.T.C. ¶ 50,496 (3d Cir. 1990). Commentators have offered widely divergent views and theories on the captive issue. Winslow, *supra*, at 80 & n.3. See, e.g., Barker, *Federal Income Taxation and Captive Insurance*, 6 VA. TAX REV. 267 (1986) (deduction only if captive owned by persons other than insured); Bradley & Winslow, *supra* note 5 (deduction if captive not sham); Knight & Knight, *Disregarding the Separate Corporate Entity of Captive Insurance Companies: A Violation of the Moline Properties Doctrine?*, 14 J. CORP. L. 399 (1989) (*Moline Properties* supports deduction); O'Brien & Tung, *Captive Off-Shore Insurance Corporations*, 31 NYU INST. ON FED. TAX'N 665 (1973) (deduction if captive can pay losses); Sachs, *Principles for Taxing Foreign Captive Insurance Companies*, 1 AM. J. TAX POL'Y 45 (1982) (deduction where financial ability to handle risks); Singer, *When the Internal Revenue Service Abuses the System: Captive Insurance Companies and the Delusion of the Economic Family*, 10 VA. TAX REV. 113 (1990) (IRS handling of this issue has been abusive in developing illegitimate doctrine); Taylor, *Taxing Captive Insurance: A New Solution for an Old Problem*, 42 TAX LAW. 859 (1989) (examine issues from insurer's side); Winslow, *supra* (either result is theoretically justified, but denial of deduction must be based on tax avoidance principles and a finding that the business purpose of the arrangement is outweighed by the tax avoidance).

The self-insurance issue was settled by amendment of the Internal Revenue Code. The nondeductibility of self-insurance was eroded several years ago by cases allowing accrual of deductions for uncontested workers' compensation liabilities that were still unpaid. Winslow, *supra*, at 90 n.46. See *Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983); *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772 (9th Cir. 1975). For a complete exposition on this issue, see Bradley & Winslow, *supra* note 5. The economic performance standard was put into the Code, in part, in order to delay deductions on account of tort and workers' compensation claims until payment. See I.R.C. § 461(h). See also Winslow, *supra*, at 90-91.

¹⁰ See Treas. Reg. § 1.162-1(a). See also Winslow, *supra* note 9, at 80.

¹¹ See Winslow, *supra* note 9, at 86-88, 138, 159-62 & n.240.

¹² See Johnson, *Retrospective Planning for Future Profits*, RISK MANAGEMENT, April 1989, at 69.

¹³ Brief of Appellant at 44-45, *Stearns-Roger Corp.*, 774 F.2d 414 (10th Cir. 1985) (based on expert witness testimony); Winslow, *supra* note 9, at 138 & n.239.

¹⁴ For examples referring to the concept, see, e.g., Johnson, *supra* note 12; Davis, *IRS*

This Article is the author's third in a series on cash flow plans.¹⁶ It builds on earlier works by analyzing business expense deductions with respect to premiums paid under retrospectively rated insurance policies, which present an unusual context for determining the elements of the definition of insurance. It first describes the elements of the definition of insurance.¹⁷ Next, it describes retrospectively rated insurance plans in some additional detail and reviews their history under the tax law.¹⁸ The Article then suggests that the deductibility of such premiums should be determined through a tax avoidance analysis¹⁹ similar to that which the author has suggested for analysis of captive insurance arrangements, rather than a technical definition of insurance.²⁰ This approach should lead to the conclusion that some such arrangements can generate a premium expense deduction, while many used in practice do not.

I. DESCRIPTION OF RETROSPECTIVELY RATED INSURANCE

The premium amount under a retrospectively rated arrangement comes from a formula. The formula which is present in the contract at the outset determines the stated premium amount from losses expected for the insured. The premium amount is regularly adjusted to reflect actual losses throughout the period of coverage.

Such a formula for retrospective rating must account for several charges. Expected losses are covered by a loss conversion factor. That factor also includes claims handling expenses, state taxes and any federal excise tax. In addition, the contract likely will call for a charge denominated a basic premium. Within the basic premium are charges for administrative expenses, plus an amount compen-

¹⁴ For examples referring to the concept, see, e.g., Johnson, *supra* note 12; Davis, *IRS Targets Retrospectively Rated Insurance Programs*, CASH FLOW, April 1987, at 37, 38.

¹⁵ For works discussing retrospectively rated plans and then focusing on other cash flow arrangements, see Winslow, *supra* note 9, at 86-87, 138, 150-62; Note, *Federal Taxation Concepts in Corporate Risk Assumptions: Self-Insurance, the Trust, and the Captive Insurance Company*, 46 FORDHAM L. REV. 781, 799-803 (1978).

¹⁶ Bradley & Winslow, *supra* note 5; Winslow, *supra* note 9. This Article does not develop anew many of the background aspects and issues of cash flow programs. If the instant discussion appears to be brief, then please refer to the two earlier works. An effort has been made to minimize repetition among these works but some duplication has undoubtedly crept in, as should be expected with works touching upon similar topics by the same author.

¹⁷ See *infra* notes 21-39 and accompanying text.

¹⁸ See *infra* notes 40-50 and accompanying text.

¹⁹ See *infra* notes 51-130 and accompanying text.

²⁰ See Winslow, *supra* note 9, *passim*.

sating the insurer for bearing the risk that losses will rise beyond the point where the premium can be adjusted to reflect additional losses.²¹

Retrospectively rated insurance comes in a great variety of forms.²² The financial attractiveness to the insured of these forms varies greatly. A common and fairly uncomplicated form, giving the insured the largest financial advantage, is the "paid loss retro." Under that form the insured pays the premium amount to the insurer when and to the extent actual losses arise and must be paid.

An alternative retro plan, with potentially much less freedom, restricts the range of possible retrospective adjustment of the premium amount. The premium in this form is thus confined to fixed minimum and maximum limits. In addition, the obligation to pay the premium may be freed from the payment of losses. If it is desired to defer payment of the premium, a schedule of fixed terms can be provided by a note from the insured to the insurer. Use of a note attempts to isolate the insurance and financing parts of the arrangement.

The financing aspect of this last alternative can be handled differently. The note might be replaced by an investment credit mechanism. This variation calls for the premium to be paid at the time of the contract. That amount should approach the principal amount of the note used in connection with a deferred premium retro to pay the stated premium. The insured also gets "credit" for increases upon the "loss fund" held by the insurer. This "investment credit" accrues at a set rate on the fund. The rate applies to the premium amount (less returns), plus accumulated credits, less the basic premium, premium taxes, loss payments and formula loss expenses.²³ The "credit" used in connection with this variation shows the insured who has paid the premium amount at the time

²¹ See generally R. RIEGEL & J. MILLER, *INSURANCE PRINCIPLES AND PRACTICES* 380 (5th ed. 1966); E. VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 94 (3d ed. 1982).

²² For discussion of the possible variations, see R. RIEGEL & J. MILLER, *supra* note 21, at 378-81.

²³ See generally Priv. Ltr. Rul. 82-48-022 (Aug. 27, 1982); Priv. Ltr. Rul. 86-04-072 (Oct. 30, 1985).

The advantage in the investment credit variation of retros is present only if the loss payments occur at the time and in the amount expected. Should payments of losses occur as estimated, no additional amounts from the insured will be needed by the insurance company. The credit formula will otherwise dampen any positive increment or increase amount of the refund. The insured may, however, lose the desired advantage of this retro alternative if losses are greater than were expected or are paid faster than was expected. In such cases, the insurer cannot earn the anticipated return on the "loss fund."

of the contract that it retains benefits from funds transferred to the insurance company, even if it does not delay payment of the premium as in the first two retro variations discussed above.

In order to analyze these retrospective plans in light of the general insurance authorities, it will be necessary to review the theoretical literature on the plans and trace their history in the tax law

II. THE DEFINITION OF INSURANCE AND RETROSPECTIVELY RATED ARRANGEMENTS

Economics and insurance scholars have written about the theories behind retrospectively rated policies for well over 40 years, but little consensus has emerged. The majority, however, tend to find some insurance element within the plans and conclude that such arrangements can be considered insurance.

Under long established doctrine,²⁴ insurance is considered to be present for tax purposes if there is risk shifting and risk distribution.²⁵ Risk shifting generally means that the insured has transferred the risk from itself to another party, the insurer.²⁶ Risk distribution, although sometimes less clearly understood than risk shifting, refers to the pooling process in which the insurer, through the collection of premiums from numerous insureds, spreads the risks across the body of those insureds.²⁷

In this light of insurance theory from the tax law, and using concepts similar to those used in the tax authorities, a fair number of writers cast some doubt upon the characterization of retros as insurance, or accept that conclusion only grudgingly. Some writers in this group describe retros as partial self-insurance,²⁸ referring to the payment of losses with the range of premium variability. Others treat the concepts as less deserving of an insurance characterization, sometimes referring to it as "quasi self-insurance" and attempting

²⁴ See generally Winslow, *supra* note 9, at 93-101.

²⁵ *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

²⁶ *Id.* at 541-42; Rev. Rul. 65-57, 1965-1 C.B. 56.

²⁷ *Commissioner v. Treganowan*, 183 F.2d 288, 291 (2d Cir. 1950).

²⁸ M. GREENE, RISK AND INSURANCE 758 (1968) ("employer becomes a partial self-insurer, but he uses the commercial insurer to limit his losses"); A. MOWBRAY & R. BLANCHARD, INSURANCE: ITS THEORY AND PRACTICE IN THE UNITED STATES 347 (4th ed. 1955) ("What retrospective rating amounts to is self insurance within limits, and an agreement that the insurer will give the usual service to the risk, particularly in settlement of losses.").

to isolate the insurance elements in such a plan.²⁹ All of these essentially negative views of the issue apparently were developed because until the losses exceed the amount corresponding to the maximum premium, the insurer does not bear any losses because the premium adjusts to reflect the losses up to that point.³⁰ Thus, these writers often conclude that the insured has not bought insurance except to the extent its premium cannot exceed a stated maximum³¹ or the amount of insurance increases as the maximum premium decreases.³² They also sometimes refer to the insurers' indemnity or agreements to provide claims services as insurance elements.³³ Ultimately, these commentators conclude with the qualification that retros are insurance only to the extent that they have such features.

Other commentators are more positive about these arrangements. Some writers simply describe the retrospective policies as an insurance rating device.³⁴ These writers typically do not discuss

²⁹ See R. RIEGEL & J. MILLER, *supra* note 21, at 380; H. DENENBERG, R. EILERS, W. HOFFMAN, C. KLINE, J. MALONE & W. SNIDER, *RISK & INSURANCE* 389 (1964) [hereinafter DENENBERG]; G. MICHELbacher, *CASUALTY INSURANCE PRINCIPLES* 243 (2d ed. 1942); Williams, *An Analysis of Current Experience and Retrospective Rating Plans*, J. FINANCE, Dec. 1954, at 377, 399-401.

³⁰ Insurance writers of this view have remarked upon the undeniable economic resemblance of retros to self-insurance combined with excess coverage.

First, the manager must be able to compare the desirability of a retrospectively rated insured [sic] plan with a self-insured plan in which excess coverage is carried. Since the protection provided an insured by these two approaches is often very similar, the decision will be strongly influenced and perhaps even determined by cost considerations. The insurance manager, therefore, must be able to compute the cost of retrospectively rated plans under various loss assumptions.

Risk Management and General Insurance Problems, *supra* note 3, at 134. A like comparison to captive insurance has also been made.

The large corporate risk market is permeated with "special," "service," and other types of insurance plans so retrospective in nature, at least for the casualty and workmen's compensation risks, that the term "retrospective" in the risk manager's vocabulary has largely been replaced with the term "insurer retention," reflecting the nature of the competitive process in the placement of these plans.

Goshay, *Captive Insurance Companies*, in *RISK MANAGEMENT* 80, 111 (H.W. Snider ed. 1964).

³¹ H. DENENBERG, *supra* note 29, at 389; G. MICHELbacher, *supra* note 29, at 243; Williams, *supra* note 29, at 400.

³² R. RIEGEL & J. MILLER, *supra* note 21, at 380.

³³ See G. MICHELbacher, *supra* note 29, at 243; R. RIEGEL & J. MILLER, *supra* note 21, at 380; Williams, *supra* note 29, at 400.

³⁴ S. S. HUEBNER, K. BLACK & R. CLINE, *PROPERTY AND LIABILITY INSURANCE* 662-63 (2d ed. 1976); J. ATHEARN, *RISK AND INSURANCE* 403 (1977); Clark, *Problems of Insuring*

specific insurance features of retrospective policies. Nevertheless, their discussions of such plans in the context of other forms of insurance suggest that they do not take exception to the grouping of retros with insurance arrangements generally. Other writers refer to retrospectively rated plans as similar to "cost plus" contracts with the major difference being the limited range of premium variability.³⁵ Still others recognize that they have been labelled as "cost plus" plans but conclude that they are in fact "protected profit sharing plans" between the insureds and the insurers.³⁶ Such comments run to the extreme of totally denying the presence of self-insurance between the minimum and maximum premium amounts. Although the employer has complete legal and financial responsibility for losses in the case of self-insurance, in retrospectively rated plans legal responsibility for all losses is on the insurer.³⁷ Finally, two authors have concluded (with little explanation) that the use of set minimum and maximum premiums causes the arrangement to be insurance by transfer of risk and pooling of expenses, so that those who incur loss are reimbursed by those who do not.³⁸

Thus, there is substantial support among scholarly works for the conclusion that retro arrangements constitute insurance under various rationales.³⁹ Indeed, that seems to have been how the issue was initially treated in the tax law for several decades.

Domestic Risks in the Domestic and Foreign Insurance Markets, in *Risk Management* 66, 75 (H.W. Snider ed. 1964).

³⁵ E. VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 94 (3d ed. 1982). See also GOSHAY, *supra* note 3, at 42 n.10 ("Retrospective plans, despite their limited 'cost plus' nature, have significant insurance features.").

³⁶ J. MAGEE & D. BICKELHAUPT, *GENERAL INSURANCE* 436 (7th ed. 1964); J. MAGEE, *PROPERTY INSURANCE* 750-51 (3d ed. 1955).

³⁷ C. KULP, *CASUALTY INSURANCE: AN ANALYSIS OF HAZARDS, POLICIES, COMPANIES AND RATES* 523 (3d ed. 1956) [hereinafter KULP]; R. GOSHAY, *supra* note 3, at 42. This conclusion was much more strongly stated than in Dean Kulp's earlier edition, where he simply stated that, "[t]he only difference between [a retro with a maximum premium] and a separate aggregate stop-loss contract is that in the latter the insured retains full legal responsibility for losses; here it rests with the insurer." C. KULP, *CASUALTY INSURANCE: AN ANALYSIS OF HAZARDS, POLICIES, COMPANIES AND RATES* 579 (rev. ed. 1942) [hereinafter KULP REVISED EDITION]. One still might doubt whether he intended the broad conclusion described in the text since he elsewhere stated that the plan "retain[ed] the insurance principle by limiting both the maximum and minimum premiums." *Id.* at 519.

³⁸ I. PFEFFER & D. KLOCK, *PERSPECTIVES ON INSURANCE* 340 (1974).

³⁹ An expert witness often used by the government in insurance tax cases testified in one captive insurance case that the majority of retros consist of insurance combined with a structured arrangement for paying for losses. Brief of Appellant, at 44 & n.26, *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985). See also Winslow, *supra* note 9, at 138 n.239.

III. A BRIEF HISTORY OF RETRO ARRANGEMENTS

A. *Origins in World War II*

Although not a new idea at the time, retrospective insurance arrangements rose to significance during the early 1940's.⁴⁰ Retrospective rate making grew out of a "germ of an idea" in 1932, and was applied as a modified system of limited self-rating for relatively large risks.⁴¹ This concept was developed for the war effort in a plan covering contractors' workmen's compensation, employers' liability, automobile liability, and comprehensive liability hazards under a special United States War Department Plan.⁴² This plan was implemented as a means of reducing the costs of the war effort by giving insureds coverage essentially "at cost."⁴³

The insurance nature of these contracts generally was not questioned for tax purposes at that time. The contemporary writings evidence an unquestioning acceptance of the contracts as insurance.⁴⁴ The most pressing tax question concerned the so-called return premiums under the plan. This question arose after the enactment of the Revenue Act of 1942 and was addressed in the Treasury Department's Regulations. The insurance companies wanted those premiums to be treated as "unearned premiums" and hence deducted from gross premiums in arriving at net underwriting income. The regulations accommodated this concern by providing that,

In computing "premiums earned on *insurance contracts* during the taxable year" the amount of the unearned premium shall include (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War

⁴⁰ G. MICHELBACHER, *supra* note 29, at 243; KULP REVISED EDITION, *supra* note 37, at 574. Dean Kulp concluded that, "[b]oth in theory and fact the result is surely insurance whether costs are figured prospectively or retrospectively." *Id.* He asserted that, "[t]he retrospective is the method of the earliest attempts at pooling hazards, the assessment society or group." *Id.* The loss experience of a group is, however, not the relevant experience of the retros examined in this Article, which concerns the loss experience of the individual insured.

⁴¹ KULP, *supra* note 37, at 519.

⁴² KULP REVISED EDITION, *supra* note 37, at 576 n.64.

⁴³ See Tye, *An Analysis of the Comprehensive Insurance Rating Plan*, 1943 INS. L. J. 3, 3-4 (1943); Gen. Couns. Mem. 35,269 (March 15, 1973).

⁴⁴ See Tye, *Federal Taxation of Insurance Companies and Their Problems*, 21 TAXES 594 (1943); Tye, *supra* note 43, at 3, 4.

Department Insurance Rating Plan," and which return premiums are therefore not earned premiums.⁴⁵

Thus, the government initially treated these contracts as insurance and appeared to resolve the one principal tax issue in favor of taxpayers.

B. The Unearned Premium Issue

For some years this understanding remained in place. Then, the Service raised an issue regarding the unearned premiums, and this inquiry also led to a collateral development of principal importance for our purposes. In the course of its work on the unearned premium issue, the Service provided some very general standards relating to the insurance nature of the contracts.

In the 1950's and 1960's, the Service began to take the position that the potential (*i.e.*, contingent) retrospective refund was not an unearned premium. It sought to disallow deduction of that amount from gross premiums in determining net underwriting income of the issuer. In Revenue Ruling 67-225, it reasoned that the Treasury Regulations meant that "a retrospective rating credit may be deducted in computing premiums earned only when the liability therefor becomes fixed and reasonably ascertainable in amount in the same sense that there is a fixed liability to return the unearned premium upon cancellation."⁴⁶ This position delayed the availability of the credit by conditioning its timing on the "all events" test of the Treasury Regulations under section 461 governing accrual of liabilities generally.⁴⁷

⁴⁵ T.D. 5236, 1943 C.B. 519, 523-24 (March 1, 1943) (emphasis added). For the current version of the regulation, see Temp. Treas. Reg. § 1.832-4(a)(3) (as amended in 1988).

⁴⁶ Rev. Rul. 67-225, 1967-2 C.B. 238, 242. For a published ruling and Technical Advice Memorandum following Rev. Rul. 67-225 on a similar issue, see Rev. Rul. 70-480, 1970-2 C.B. 142 and Tech. Adv. Mem. 7003271130A (March 27, 1970). *Cf.* Rev. Rul. 59-417, 1959-2 C.B. 170 (stock casualty insurance company should include maximum premiums earned during taxable year in its gross income and deduct the return premiums only in the year in which the liability therefore accrues); Priv. Ltr. Rul. 5602276130A (Feb. 27, 1956) (same). See also Rev. Rul. 67-180, 1967-1 C.B. 172 (liability for retrospective rate credits based on experience with respect to casualty insurance contracts issued by an accident department of a life insurance company are treated as a reserve for dividends to policyholders rather than unearned premiums or return premiums); Priv. Ltr. Rul. 6705056220A (May 5, 1967) (same). During this period, the Service gave private rulings opining whether a particular plan was a rate credit or retrospective rating plan based on experience within the meaning of the regulations. See Priv. Ltr. Rul. 5710096020A (Oct. 9, 1957).

⁴⁷ Treas. Reg. § 1.461-1(a)(2) ("all events" fix fact of liability and amount determinable with "reasonable accuracy"). See also Winslow, *supra* note 9, at 90.

Taxpayers challenged this position in the courts. The dispositive case, *Bituminous Casualty Corp. v Commissioner*,⁴⁸ interpreted the Treasury Regulations dealing with the unearned premium issue as permitting insurers to treat estimated amounts returnable under a retro as "unearned premiums." The court found that the regulations originally were intended to make the same adjustments for both tax and insurance accounting purposes. "Liability," as used by the regulations denoted the insurance industry definition rather than the meaning given it in the "all events" test governing accrued deductions generally. The Service later accepted this result by revoking the previously published ruling.⁴⁹

The unearned premium issue subsequently became uncontroversial. The Service gave private rulings with respect to it. The Service ruled that retrospective refund reserves could be given the treatment accorded to "unearned premium" reserves.⁵⁰

C. The Current Retro Issue—Insurance Characterization of the Retro Contract

These early authorities indirectly bear on the current issues facing retrospectively rated plans. They serve to illustrate the somewhat lengthy acceptance of such plans as insurance by the government. Moreover, such rulings by the government also provided the germ of a theory upon which such characterizations could be justified.

1. The Basic Framework of Issues

Whether retros constitute insurance contracts also determines the deductibility of the insured's premium expense. This represents the current tax issue for retros. As with captives, such a deduction rests on the section 162 regulations that specify a business expense deduction from gross income for "insurance premiums against fire, storm, theft, accident or similar losses in the case of a business."⁵¹

⁴⁸ 57 T.C. 58 (1971).

⁴⁹ Rev. Rul. 73-302, 1973-2 C.B. 220.

⁵⁰ Priv. Ltr. Rul. 86-04-072 (Oct. 30, 1985); Priv. Ltr. Rul. 82-48-022 (Aug. 27, 1982).

⁵¹ Treas. Reg. § 1.162-1(a). For years, *Midwest Motor Express, Inc. v. Commissioner*, 27 T.C. 167 (1956), *aff'd on other grounds*, 251 F.2d 405 (8th Cir.), *cert. denied*, 358 U.S. 875 (1958), was taken to support a general characterization of retros as "insurance." *Midwest Motor* involved the proper year for an accrual deduction under the "all events" test. The issue concerned the accrual of an adjustment in the retrospectively rated premium occasioned by a particular claim arising from an accident in 1948 which resulted in a setting up of a

Insurance premiums typically have been considered to generate an accrual expense when incurred. The recent retro tax issue, regardless of the payment features involved, thus, turns on whether a retrospectively rated policy constitutes "insurance."⁵² Some recent developments, discussed below, complicate matters for premium expense deductions under a deferred premium payment arrangement, but the initial and basic question in all cases has been the insurance characterization of the arrangement.

The authorities discussed above, considering whether a contract is insurance, require that the contract shift risk. That characterization does not necessarily follow from the use of a policy from a commercial insurer.⁵³ Given a variable premium to be paid to a third party insurer, the tax issue for retros is: how much risk shifting suffices to qualify a retrospectively rated contract as "insurance?"

The authorities concerning the unearned premium issue characterized the retro contracts. The Service must have agreed that a retrospectively rated arrangement could be "insurance." That characterization appeared to be present if the insurer could not adjust the premium to correlate exactly premiums and losses. That possi-

reserve by the insurer in 1950 to cover the claim. The taxpayer deducted that expense in the taxable year 1952, when the claim against the taxpayer was paid, and paid the adjusted premium the next taxable year. The Service argued that the adjustment in the premium expense should have been accrued and deducted prior to those years, "conced[ing] that the premium payment [was] a proper deduction." 27 T.C. at 186. The Tax Court found, in light of the above facts and the fact no recomputation of the premium was to occur after August 1951 unless the parties disagreed as to the amount of the reserve, that the premium expense had accrued before the year in which the taxpayer claimed the deduction. Because it was assumed that the accrued premium expense arose from an insurance transaction, particularly in light of the Service's concession just quoted, the case was thought to support the insurance characterization of retrospectively rated policies.

As suggested by *Midwest Motor*, a retro, even if the retro constitutes insurance, involves the further issue of the proper year of the deduction for the premium expense. Although this accrual issue will be considered below, it should be noted that an insured reporting income on an accrual basis must pass two tests to achieve a current deduction under I.R.C. § 461. First, the taxpayer must meet the "economic performance" test of section 461(h). If the contract is one of insurance, economic performance generally takes place within the policy period. H. R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 875 (1984), *reprinted in* 1984 U.S. CODE & ADMIN NEWS 1445, 1563. Second, the taxpayer must satisfy the "all events" test, which allows a deduction "for the taxable year in which all the events have occurred which determine the fact of the liability (for the premium) and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.461-1(a)(2). *See also* I.R.C. § 461(h)(4).

⁵² The stated premium would be paid in the policy period. The case of a "deferred" payment, which presents some special difficulties, will be discussed below.

⁵³ Any of these plans will be analyzed according to its terms and substance. In *Helvering v. Le Gierse*, 312 U.S. 531 (1941), the Supreme Court held that an arrangement involving a large commercial insurer did not constitute "insurance" because it did not shift risk when analyzed as a whole.

bility of an insurance characterization logically extended to the context of the deductibility of the premium expense.⁵⁴

2. *Early Collateral Analysis Generated by the Unearned Premium Issue*

Revenue Ruling 67-225,⁵⁵ which is discussed above in connection with the unearned premium issue, gave an early suggestion as to how the Service might view this issue. In the course of that ruling, the Service pointed to the need for restrictions on the adjustment range for the premiums before a contract could be insurance. The Service stated that such an adjustable premium must be "subject to minimum and maximum limits thus guaranteeing on the one end, that every premium paid by a policyholder takes into account risk charges and loading elements and on the other end that the contract is one of insurance rather than mere bookkeeping for a fee."⁵⁶

The Service subsequently pursued this course in private rulings dealing with "unearned premiums," after Revenue Ruling 73-302 revoked Revenue Ruling 67-225's position on that issue.⁵⁷ These rulings deal with issues other than the deductibility of the premium, but there is between the unearned premium and premium deductibility inquiries a common issue: the characterization of retros as insurance. The conclusions reached in both contexts should be the same. In those private rulings on the unearned premium issue, the Service found that since the policies called for restrictions on the amount of possible premium adjustment, the insurers "assume[d] a meaningful amount of insurance risk under the policy."⁵⁸

These rulings failed to specify the permissible limits for premium adjustments. But, if retros cannot be "insurance", these rulings gave the Service a perfect opportunity to air such a view. The consistent treatment of the retros as "insurance" with respect to the unearned premium issue well supported the notion that those arrangements were insurance for other purposes, including deductibility of the premium expense, if meaningful limits were imposed on premium variability

⁵⁴ See Note, *supra* note 15, at 800.

⁵⁵ 1967-2 C.B. 238.

⁵⁶ *Id.* at 239.

⁵⁷ See Priv. Ltr. Rul. 86-04-072 (Oct. 30, 1985); Priv. Ltr. Rul. 82-48-022 (Aug. 27, 1982).

⁵⁸ See Priv. Ltr. Rul. 86-04-072 (Oct. 30, 1985); Priv. Ltr. Rul. 82-48-022 (Aug. 27, 1982).

This analysis gave some significant guidelines, but they were not crystal clear. The Service's rulings implied that a retro not limited in its premium adjustments would not be insurance. It would, in substance, be self-insurance: the insured would essentially pay its own losses. That result obtained in *Steere Tank Lines, Inc. v. United States*.⁵⁹ The *Steere Tank Lines* decision involved the only adjudicated instance prior to the 1980's of a scheme similar to a retrospectively rated insurance contract lacking meaningful or substantial premium limits. *Steere Tank Lines* was apparently distinct from the situations underlying the unearned premium issue rulings because it involved an essentially unlimited retrospective adjustment of the premium. That contract prevented any shift of the risk to the insurer from the insured-taxpayer, except in the event of the "insured's" insolvency. *Steere Tank Lines* underscored the tendency (already seen in the Service's rulings) to look for reasonable restrictions on the variability of premiums in determining whether an arrangement constitutes insurance.

By the early or mid-1980's, this collection of authorities suggested three propositions relating to retros and a premium expense deduction. First, the Service had abandoned the unearned premium issue. Second, the Service, in the course of dealing with the unearned premium issue, had adopted a general standard for determining whether a retro contract constituted insurance, and that stated standard provided some support for a premium expense deduction with respect to those retro contracts approaching that standard. Third, the Service apparently had no interest in questioning the Subchapter L treatment of insurance companies issuing retro contracts. Such challenges would have seemed appropriate if retro policies were not contracts of insurance.

⁵⁹ 76-2 U.S.T.C. ¶ 9526 (N.D. Tex. 1976), *aff'd per curiam*, 577 F.2d 279 (5th Cir. 1978), *cert. denied*, 440 U.S. 946 (1979).

The government claimed the transaction in question, which had significant surety bond elements, amounted at most to self-insurance. The taxpayer claimed that it was "a form of retrospective policy." The Court of Appeals stated that:

In the present case, there was no shifting of the risk, since Steere [the taxpayer] was obligated to pay all losses. The premium contract amount could be used only to pay losses suffered by Steere or its owner-lessors, but Steere was obligated to pay premiums for its owner-lessors, so in effect, Steere's losses were to be paid only out of a fund made up of premiums Steere had paid.

Thus, there was no risk distribution by Steere either.

557 F.2d at 280. The court drew additional support for this result from the fact that the taxpayer received a surety bond rather than a "certificate of insurance."

3. *Change in Direction by the Service*

In the 1980's the Service altered its approach to characterizing retros. This change in course did not become apparent at once. Only through use of hindsight is it possible to observe that the signals of change surfaced early in that decade. For years, the Service had seemed relatively satisfied to allow a premium expense deduction for one insured under a retro arrangement if the retrospective rate adjustment was based on the loss experience of a group of insureds.⁶⁰ An early sign that the Service had rethought its positions appeared in a published ruling on this type of retro issue. Nothing on the surface of that ruling challenged the notion of insurance that had been derived from the unearned premium issue authorities of the Service.

In 1983, the Service issued this published ruling, Revenue Ruling 83-66,⁶¹ based on a cash method taxpayer who bought malpractice insurance from a stock casualty company. An annual policy was issued under a master agreement between the insurance company and the taxpayer's medical society. A refund provision permitted a refund of some amount of the premium if the insurance company paid fewer losses than expected. The Service ruled that the insured could take a deduction for the premium expense despite the refund clause.

The deduction was sustained in this instance. But this ruling shifted subtly from the previously understood position of the Service. The reserve premium at issue consisted of the "difference between the actuarially computed premium necessary to cover anticipated losses based on the current trend in the malpractice area and the premium necessary to cover malpractice losses if the insurance company achieved a favorable loss experience for the group," apparently referring to the medical society as the "group."⁶² The Service ruled that the entire premium payment, consisting of the reserve premium as well as the basic premium, shifted risks from

⁶⁰ See generally *Priv. Ltr. Rul. 79-32-037* (May 9, 1979) (retro policies from insurer to United States law firms not discussing risk-shifting).

⁶¹ 1983-1 C.B. 43.

⁶² It has been asserted that this ruling involved a mechanism "which based the amount of any retrospective rate credit on the aggregate loss experience of the insurance company."

"Tech. Adv. Mem. 86-37-003 (May 23, 1986). The retrospective credit amount in Revenue Ruling 83-66 was determined by the loss experience of the group, and that term seemed to refer to the medical society, which presumably constituted a subset of the insurer's business. Therefore, the assertion in the Memorandum quoted above appears to be inaccurate.

the insured to the insurance company, "because the reserve premium was available for the losses of the group as a whole."⁶³

Revenue Ruling 83-66 failed to note any disagreement with the Service's previous positions regarding the insurance characterization of retrospectively rated contracts. But later developments permitted a more complete appreciation of this published ruling's attention to the rating formula's relation to group losses instead of an insured's losses.

The possibility of a Service challenge to deduction of retro premium expenses always existed despite the absence of any express objection in the authorities discussed above. A principal function of a retrospectively rated contract is to bring together the amount of actual losses and premium expense for the insured. Given this goal, retros presented a vulnerability that at least some forms of retros were not "insurance," since a premium determined with fair closeness by the insured's losses might not shift or distribute risk. In such cases, the insured effectively bears its own risks as it will pay its own losses.

This possibility of a challenge became a fact with two 1986 Technical Advice Memoranda issued by the Service with respect to the deductibility of premium expense associated with retros.⁶⁴ These memoranda concluded broadly that payments denominated as retrospectively rated premiums were not insurance premiums so long as the amount to be paid is determined by the insured's losses.

The Service's basic position was said to be that "[a]n arrangement constitutes insurance *to the extent* that it provides for the risk shifting and risk distribution."⁶⁵ The Service then purported to isolate the basic or excess loss premium, as paid for a true "insurance" function, from the converted losses. The latter figure was a function of actual losses. The Service stated that the authorities allow this isolation of "separable elements of the policy" that are "clearly discernable."⁶⁶ It then found that part of the premium that constituted the "converted losses" was a non-deductible "reserve

⁶³ Rev. Rul. 83-66, 1983-1 C.B. at 44.

⁶⁴ See Tech. Adv. Mem. 86-37-003 (May 23, 1986); Tech. Adv. Mem. 86-38-003 (June 11, 1986).

⁶⁵ *Id.* The authorities cited were the following: *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950); Rev. Rul. 60-275, 1960-2 C.B. 43; Rev. Rul. 77-316, 1977-2 C.B. 53.

⁶⁶ Tech. Adv. Mem. 86-38-003; Tech. Adv. Mem. 86-37-003. The Technical Advice Memoranda cited for this proposition *National Savings Life Ins. Co. v. Commissioner*, 84 T.C. 509 (1985).

for losses.” It reached this conclusion “even where the funds are transferred to and administered by an independent agent or by an insurance company”⁶⁷ Thus, in one case, the minimum premium was the most that could be called insurance. Similarly, in the other case only the basic premium⁶⁸ could be entitled to an insurance characterization.⁶⁹ Other than those amounts, the premium moved with the losses and could not “to that extent” be seen as insurance under the Service’s approach.

This approach clashed with previous treatment of retros, because it had generally been thought that a retro with a reasonable premium adjustment range could be insurance. Retros with unlimited premium adjustment ranges clearly were subject to challenge regardless of a novel approach such as isolation of the elements of the contract. In pursuing a broad plan of attack, the Service ignored a more restrained and judicious approach not simply with respect to the issue of insurance characterization. For example, the Service could have found that the premium expense deduction was not properly accrued.

In both cases, the Service noted its view was “reinforced” since the “expected loss portion of the premium became payable only as specific claims of the taxpayer were asserted and paid by the insurance company”⁷⁰ That observation undoubtedly supports the Service’s conclusion as to deductibility, but it also shows that there was no need for innovation in these cases, such as an attempt to define insurance. An insurance premium under a retrospectively rated contract can satisfy the normal tests of accrual deductions. It may be sufficiently certain so that the fact of liability is established under the first prong of the “all events” test.⁷¹ The premium

⁶⁷ Tech. Adv. Mem. 86-38-003; Tech. Adv. Mem. 86-37-003. See *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931).

⁶⁸ This premium amount might be thought not to constitute a payment for insurance, since the premium probably was set so low that payment of losses exceeding that amount was not uncertain. See *infra* notes 111-30 and accompanying text.

⁶⁹ The Service’s Technical Advice Memoranda described *Midwest Motor*, discussed *supra* note 51, as concerning only the proper timing of the deduction. The case was, thus, said not to be “relevant [in determining] whether the total amounts billed constitute properly deductible insurance premiums.” A characterization of the case as concerning only the timing of the deduction slights the treatment of the arrangement as insurance by both parties and the court. That assumption bears on the timing issue and was a natural implication to draw from *Midwest Motor*.

⁷⁰ Tech. Adv. Mem. 86-38-003 (June 11, 1986).

⁷¹ The potential accrual of retrospectively rated premium expenses draws significant support from the *Midwest Motor* case, discussed *supra* note 51.

amount, despite variability, can usually be determined with "reasonable accuracy," in accord with the second prong of the "all events" test.⁷² In those limited, and avoidable, cases where retro premium liability depends on a substantial condition the "all events" test, however, would be unsatisfied.⁷³ Since the payment of losses stood as a condition for liability in the two cases considered in the

Under the "all events" test, an accrual liability can be deducted if the fact and amount of liability can be established. The fact of liability would be fixed with respect to a retro premium when the insured becomes obligated to pay an insurance premium upon the execution of the insurance policy. *Midwest Motor Express*, 27 T.C. 167. See *United States v. Hughes Props, Inc.*, 476 U.S. 593 (1986) (casino allowed to deduct buildup in "progressive" slot machines as accrued liability); *Lawyers' Title Guaranty Fund v. United States*, 508 F.2d 1 (5th Cir. 1975) (accrued commissions deductible despite possible later reduction); *Consolidated Foods Corp. v. Commissioner*, 66 T.C. 436 (1976) (same for accrued rental); *Electric Tachometer Corp. v. Commissioner*, 37 T.C. 158 (1961) (same for accrued moving expense). See also *Geo. K. Herman Chevrolet, Inc. v. Commissioner*, 39 T.C. 846, 853 (1963) ("An otherwise proper deduction should not be disallowed in the year it was paid or incurred because of the existence of a possibility that at some future date the taxpayer might receive a reimbursement therefor."). The premium variability would constitute a condition subsequent not precluding a deduction. See *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, 217 (2d Cir. 1952) (deduction allowed for commission expenses despite possible failure to execute final contract and potential variance in commission amount due to quantity), *cert. denied*, 344 U.S. 874 (1952); *Ohmer Reg. Co. v. Commissioner*, 131 F.2d 682 (6th Cir. 1942) (deduction allowed for "reserve for sales agents' commissions" because only contingency was collection of sales price). On the other hand, an obligation that does not mature into a liability until the satisfaction of a material condition precedent cannot meet the "all events" test. See *United States v. General Dynamics Corp.*, 481 U.S. 239, 107 S. Ct. 1732 (1987) (no deduction for estimates of employees' medical expenses where claims not reported); *Field Enterprises, Inc. v. United States*, 348 F.2d 485, 488 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1009 (1966) (no deduction for quality bonuses contingent on delivery acceptance and payment).

⁷² "Reasonable accuracy" in determining the amount of the deduction is needed, not absolute certainty. See *Treas. Reg. § 1.461-1(a)(2)*. Despite the variability of the premium with retros, extensive practice by insurance companies should permit a sufficiently accurate projection to support a deduction. Thus, if the stated premium is equal to the projection, it should be considered properly accrued under the reasonable accuracy prong of the all events test.

⁷³ A contingency may be significant enough to be a condition precedent. Such a condition would cause the stated premium to fail the "all events" test. *W. S. Badcock Corp. v. Commissioner*, 59 T.C. 272, 284 (1972), *rev'd*, 491 F.2d 1226 (5th Cir. 1974). See *Wien Consolidated Airlines, Inc. v. Commissioner*, 60 T.C. 13, 15-16 (1973), *aff'd*, 528 F.2d 735 (9th Cir. 1976); *Buckeye Int'l, Inc. v. Commissioner*, 49 T.C.M. 376 (1984). This distinction seems rather artificial and not well adapted to answering these questions, in addition to being somewhat elusive. See *Gunn, Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 28-29, 29 n.133 (1984). But the courts use that test in deciding cases.

The retrospectively rated premium should be considered fixed so long as it is not conditional upon such events as a payment of losses. A condition subsequent, such as losses lower than those expected, may generate a refund. A refund should be included in income in the year it becomes determined. See *Consolidated Foods Corp.*, 66 T.C. 436; *Treas. Reg. § 1.461-1(a)(2)*.

memoranda, as it stands typically for the paid loss retro, no accrual deduction was allowable. And that result was absolutely clear under existing law. The Service, however, bypassed such an easier route in its memoranda.

From the above it should also be clear that the Service paid no attention to the range of possible premium adjustment in those two cases. It might have found that the range was not sufficiently confined to shift or distribute risk. The broad approach, which ignores the limits on the range of variability, seems designed to challenge retros with relatively restricted ranges of premium adjustments. If a contract cannot be insurance to the extent the premium increases together with the losses, then a possible adjustment in the premium will disqualify a retro's insurance characterization to that extent. This group of adversely affected plans must necessarily encompass all retros, even those designed with relatively tight premium adjustment limits that appear to have definite insurance elements.

One reason the Service may have bypassed these less controversial or innovative rationales might have been to facilitate a forthcoming attack on all retros, including even those with relatively tight premium adjustment ranges. If a court can be convinced to disallow the insurance premium expense deductions for a paid loss retro simply due to the presence of retrospective rating, the Service can expand its attack in subsequent cases. That is how the Service litigated the captive insurance cases. Its litigation strategy called for establishment of a broad principle in the weaker captive cases before turning to the stronger cases in which the argument for insurance treatment was more plausible.⁷⁴ The Service's memoranda, of course, failed to specify whether the new approach to retros would be followed to its logical extreme, but some contracts previously thought to be insurance would clearly not be so characterized under the new approach.⁷⁵

⁷⁴ See Bradley & Winslow, *supra* note 5, at 220-26.

⁷⁵ At one time, the Service seemed prepared for a broad challenge to retros and other cash flow programs in connection with the promulgation of regulations implementing the economic performance standard of I.R.C. § 461(h). The possibility was that the regulations might attempt to define insurance to exclude retro arrangements and other cash flow programs.

This possibility was suggested from the legislative materials accompanying the 1984 Act provisions concerning funded employee welfare benefit plans and the temporary regulations that were issued to implement this legislation. As a part of that legislation, I.R.C. § 419 curtails the deductions with respect to contributions to various employee welfare benefit

The strategy to reach insurance arrangements with more tightly designed features, such as fixed payment provisions, is also clear from the new proposed economic performance regulations. In the past, a fixed liability to an insurer generally achieved a current deduction under the accrual rules of the "all events" test as related above. The economic performance requirement that was added to the "all events" test in 1984 provided a third requirement for deduction of an accrued liability. Although according to the legislative history, the economic performance test, which generally delayed deductibility of accrued losses, is met in the year of the policy period for an arrangement that constitutes insurance,⁷⁶ the proposed regulations provide that for liabilities under an insurance contract "economic performance occurs as payment is made to the person to which the liability is owed."⁷⁷ This means that if an insurance policy covers the 1991 year and payment is made in 1993, then the deduction for the premium occurs in the later year with economic performance, and the regulations suggest further difficulties for a current deduction with respect to the retro premium amount even if actually paid to the insurer because there may be a refund to the taxpayer insured.⁷⁸ The deductibility of the premium expense under the deferred premium retro would, thus, clearly be delayed until

funds. Where it applies that provision puts the taxpayer-employer on the cash method for contributions to such funds, making those amounts deductible as paid to such funds. There were quickly indications that this concept included retro arrangements for employee benefits within the scope of such funds. Jenson, *The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers*, 22 GA. L. REV. 229, 262 n.138 (1988). See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit-Reduction Act of 1984*, at 777-78 (December 31, 1984) (funds so limited include contracts purchased by employers from insurance companies if subject to retrospective adjustment). The § 419 Temporary Regulations followed this pattern. Temp. Treas. Reg. § 1.419-1T.

The Proposed Regulations under I.R.C. § 461(h), however, did not offer a general definition of insurance that would sweep up retros in this manner. Instead the Regulations would adopt the definition of insurance applicable under I.R.C. § 162. Prop. Treas. Reg. § 1.461-4(g)(5) (June 7, 1990). As discussed in the text, the economic performance Proposed Regulations did, however, reach a similar result to that provided under the § 419 regulations by a different route as they would greatly affect some retro arrangements by provisions delaying premium expense deductions when the premium payment is deferred until a later period.

⁷⁶ H. R. Conf. Rep. No. 861, *supra* note 51, at 875.

⁷⁷ Prop. Treas. Reg. § 1.461-4(g)(5) (June 7, 1990).

⁷⁸ Prop. Treas. Reg. § 1.461-4(g)(8) (ex. 7) (June 7, 1990). It is, moreover, doubtful that current cash payment of an investment credit retro premium would constitute "payment" that is required for economic performance. *Id.* § 1.461-4(g)(5). Although the regulations do not define insurance, they define "payment" to exclude "an amount transferred as a refundable deposit, or contingent payment with respect to which the taxpayer may be, or become, entitled to receive a refund or credit." *Id.* § 1.461-4(g)(1)(ii)(A).

the actual payment by the insured to the insurer, even though the note firmly specified fixed terms for payment, rather than merely calling for payment by the insured as losses are paid under some of the more loosely designed plans.

The proposed regulations' approach shows again a very broad strategy and further confirms that retros with fixed premium ranges could face wide-ranging attack as suggested above. This approach, just as the definition of insurance in the technical advice memoranda, adopts a position broader than that needed to stop taxpayer abuse in these plans.

4. *Relationship of the Service's Position to Trends in Tax Area*

The Service's aggressive and expansive stance regarding the premium expense deduction with respect to retros follows the strict treatment accorded other cash flow programs. The prime examples of that sort are the captive insurance companies. Taxpayers in litigated cases have virtually without exception failed in attempts to deduct captive premium expenses.⁷⁹ In recent years, the doctrine emerging from captive cases suggests a line of attack for the Service with respect to retros.

The Ninth Circuit's opinion in *Clougherty Packing Co. v Commissioner*⁸⁰ articulates well the government's position on the captive insurance issue. In *Clougherty*, a parent company bought a policy from its subsidiary that was a captive insurance company. The court found this not to be insurance, because of its relation to the purported insured's assets. Using a form of the "economic family" theory, a concept used by the Service to aggregate the finances of all members of a corporate group when challenging captive insurance premium expense deduction, the Ninth Circuit focused on the insured-parent's assets to see if there was risk shifting or, in other words, if the parent had "divested itself of the adverse economic consequences of a covered . . . claim."⁸¹ Of course, the parent's holdings would decline in value when covered losses are paid because the assets are then leaving the subsidiary as payment of losses to unrelated parties. Since net worth of the parent would be adversely affected despite the "insurance" arrangement,

⁷⁹ See *supra* note 9.

⁸⁰ 811 F.2d 1297 (9th Cir. 1987).

⁸¹ *Id.* at 1305.

the court concluded that the arrangement effected no risk shifting and, therefore, it was not insurance.⁸²

These words might be literally applicable to retros. If amounts paid to an insurance company fail to protect from losses an asserted insured's assets in the form of its net worth, then those amounts do not constitute insurance premiums. With premiums largely varying with the losses, one might conclude that the "insured" is not insured to that extent because payment of such losses will cause its net worth to decline. This approach isolates the elements of the arrangement into insurance and non-insurance. The approach of the Service as indicated in its technical advice memoranda may be the manner in which courts will approach the retro issue, if the captive cases are any guide.⁸³

5. *Alternatives to the Service's Emerging Approach to Retros*

This set of authorities and the possible conclusions that may follow inaccurately treat many forms of retros. Some retros, perhaps most that are currently used in practice, might not be insurance if fairly evaluated. But all retros should not be subjected to this aggressive treatment. In addition, the grounds of challenging the more loosely structured arrangements, that contain only marginal insurance elements, could benefit from a more restrained and judicious approach.

The best stated guidelines for a reasonable approach to this issue are found in Revenue Ruling 67-225.⁸⁴ As discussed above, that ruling contained the notion that a retrospectively rated insurance policy or contract "subject to minimum and maximum limits guarantee[s] on the one end, that every premium paid by a policyholder takes into account the risk charges and loading elements and on the other end that the contract is one of insurance rather than mere bookkeeping for a fee."⁸⁵ This treatment was obviously imprecise, but it contained sufficient guidance, consistent with other authorities dealing with the concept of insurance such as are discussed above, that some analysis of the situation could

⁸² *Id.* at 1306.

⁸³ The Ninth Circuit stated that, "*Le Gierse* requires that an insurance arrangement negate any effect of a covered loss on the insured party's assets." *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1301 (9th Cir. 1987). Thus, the court might have intended an even more harsh result for insureds seeking a deduction than is suggested in the text.

⁸⁴ 1967-2 C.B. 238, *revoked on other grounds*, Rev. Rul. 73-302, 1973-2 C.B. 220.

⁸⁵ *Id.* at 239.

proceed, even if some parts of the analysis were not particularly clear.

a. Defining Insurance

One approach to this issue is to define insurance more precisely. That approach would be consistent with the courts' numerous attempts to define insurance in the captive context.⁸⁶ It is also the preferred course of a leading commentator, who has counseled in favor of such a resolution of such difficult tax questions and against broad anti-tax avoidance reasoning.⁸⁷

The history of retrospectively rated contracts gives us guidance in arriving at a proper definition of insurance. The long acceptance of retrospectively rated contracts as some form of insurance shows that at some point these contracts can amount to insurance.⁸⁸ It would be inexplicable for the Service, Treasury, and courts to assume that retro plans are insurance contracts for other purposes, only to conclude that they are not when considering the deductibility of amounts to be paid as insurance premiums. This result would be further surprising since for years it had been assumed that the premium expenses under retro contracts were generally deductible.⁸⁹

The difficulties with a purely definitional approach, however, quickly overwhelm the prospect of relying upon it too greatly. First, insurance theorists are not particularly clear or consistent about the nature of retrospectively rated contracts, as their comments have ranged from calling it insurance to quasi self-insurance.⁹⁰ Second, the definitions from these authorities never get any more precise than that found in Revenue Ruling 67-225 with its reference to reasonable minimum and maximum premium limits. Thus, simply defining "insurance" with respect to retrospectively rated contracts has its limits, and the tax law will require some further scrutiny of the issue.

Moreover, a strictly definitional approach would be too limited to be satisfying. If the parties to the contract were to set the minimum and maximum premiums to provide for some miniscule amount of risk distribution and risk shifting, then it would be possible to state that elements of insurance are present and argue,

⁸⁶ See *supra* note 9 and accompanying text.

⁸⁷ See Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 757 (1978).

⁸⁸ See *supra* notes 34-39 and accompanying text.

⁸⁹ See Note, *supra* note 15, at 800.

⁹⁰ See *supra* notes 34-38 and accompanying text.

therefore, that the contract should be considered to be one of insurance. But this manipulation would not be suggested by any neutral commentator and hopefully would not be respected by the courts. Perhaps someone suggesting a definitional approach would assume that some such further analysis would be appropriate, but specifying the further step would be helpful.

b. Economic Reality or Substance

It seems likely that this issue requires that the analysis advance to the level of testing the economic substance of the arrangement, rather than just its form. The tax law has long preferred substance over form in its anti-tax avoidance doctrines.⁹¹ If retrospectively rated contracts are in substance found to constitute insurance, then the tax law should allow the deduction.

The standard, derived from Revenue Ruling 67-225 and the general insurance theory authorities, that premium adjustments be confined failed to determine what size of adjustment constraints would be meaningful or substantial. The limitation must, it seems clear, have some realistic or substantial relation to the risks covered. If the insured's losses could not, even in the worst case, exceed twice the stated premium, a maximum premium of five times the stated premium would not be a substantial limit. That limit would lack substance or meaning. With no significant possibility of losses exceeding the maximum premium, the insurer bears no risk. In that case, the contract would not shift risk and would not be, substantially, insurance.⁹²

In addition, if the minimum premium covered only little more than administrative costs and was far lower than any recent loss experience, insurance features might again seem absent in terms of substance. In such a case, the insured would be unlikely to pay more in premiums than it has losses, such that its premiums could be used to cover the losses of others.⁹³ A contract containing such

⁹¹ See Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L. J. 693 (1978); Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021 (1953). See also Winslow, *supra* note 9, at 112-21.

⁹² See Note, *supra* note 15, at 802.

⁹³ Some insurance scholars see this as the function of the minimum premium. See H. DENENBERG, *supra* note 29, at 389-90 ("The minimum premium provides for the expenses of the insurer and a contingency factor, with funds obtained from the latter being used to pay insureds whose losses exceed their maximum premiums."). This statement may constitute the unspoken assumption that the basic premium is part of the minimum premium. It has elsewhere been observed that, "[t]he net insurance charge [or basic premium] is necessary

a minimum premium might be considered to lack a risk-distribution element.⁹⁴

Absent economic substance or reality, a retro arrangement would not support a finding of risk shifting and risk distribution. Thus, a retro contract, to be considered insurance, must allow for a significant chance that losses will be greater than the level corresponding with the maximum premium, or will be less than the level corresponding with the minimum premium. So structured some retros could be brought within the definition of insurance under the general insurance authorities in existence prior to the Service's technical advice memoranda.

This reasoning helps by disposing of many of the weaker retro variants, as does the definitional approach. For example, it is clear that, whether analyzed as a whole or in part and whether analyzed from a definitional approach or from a more substantive approach, certain arrangements labelled as retrospectively rated insurance are only self-insurance. If all losses are paid by the insurance company in exchange for a variable premium that increases directly with losses, substantial risk shifting is lacking. The paid loss retro with no limits on the premium variability would fail this test for substantial risk shifting as it also would fail a definitional approach. Such an arrangement is economically identical to self-insurance and should be treated as such.⁹⁵ Such a scheme was analyzed in *Steere Tank Lines v United States*,⁹⁶ which found no risk shifting and therefore no insurance.

Furthermore, an analysis of the substance of the arrangement also should dispose of additional retro variants that are slightly better designed, or one might say somewhat better disguised. A similar result should be expected where there is no significant chance that losses will lie outside the bounds of the premium adjustment range. In such instances, the contracts would substantially fail to

because the premium gained on those who pay the minimum premium is always less than the premium lost on those who pay the maximum premium." Williams, *supra* note 29, at 399. As discussed more fully below, unless the minimum premium, less the basic premium, represents an amount that may with some significant probability exceed the insured's losses, the insurance character of the arrangement may be jeopardized, but that would be on account of a reason other than the lack of risk distribution. See also *infra* note 110.

⁹⁴ Insubstantially low minimum premiums may impair the deduction, despite other insurance aspects of the plan. Such a premium suggests that there is no current liability for the premium. Losses then become a condition precedent to liability.

⁹⁵ See *Spring Canyon Coal Co.*, 43 F.2d 78. See also I.R.C. § 461(a).

⁹⁶ 577 F.2d 279 (5th Cir. 1978).

shift risk.⁹⁷ Thus, a great many contracts superficially denominated as insurance contracts and purporting to have limits on premium adjustments would not be accorded insurance characterization.

These suggestions support to this point the Service's conclusions because they would result in disallowance of the premium expense deduction where a retro specifies an effectively unlimited adjustment of the premium. The two Technical Advice Memoranda in which the Service announced its position involved such arrangements. In such a situation, the taxpayer, in substance, has failed to purchase insurance under virtually any even-handed analysis.

But for retros with further refinements and substance, a different conclusion should prevail. If the contract confines premiums, the premium does not simply move with losses, because marginal adjustments of the premium on account of converted losses occur only within a small area. With the narrowing of the adjustment range, a retro should begin to take on overall insurance features at some point, even if it is not clear precisely where that point lies.

An emphasis on substance provides a needed amendment to the Service's position. Some entire plans should be characterized as "insurance." Those arrangements to be analyzed as a whole must be those which are naturally tied together by the economics of their terms. That result should obtain for an insured who can show that it has purchased more than excess coverage of only catastrophic losses, with all other losses self-insured. Such a showing should be possible for contracts that stand as a whole from the perspective of economic substance. This conclusion would appear justified for cases where the minimum premium, excluding the amount representing the basic premium, constitutes a significant amount that may not be outdistanced by the losses. If that probability is sufficiently great that an insured would not have agreed to pay that amount without also purchasing the excess coverage, then the contract should stand as an indivisible whole. In any event, the maximum premium also must be fixed at a sufficiently small amount that losses may with some substantial possibility exceed that amount or no risk shifts.

With variability of premiums declining, an isolation of the elements of the contract loses its credibility. As the minimum premium rises, an insured would ultimately balk at entering such an agreement absent the coverage of the losses beyond an excess amount.

⁹⁷ Those defining "insurance" in this context might suggest that the presence of substantial risk shifting is an implicit part of their analysis as described above.

A very low minimum premium may make that aspect of the contract separable from the excess coverage. On the other hand, a minimum premium set at a meaningful high level should not be separated from the rest of the policy. Such a contract should be examined in its entirety for risk-shifting because the elements would be economically tied together by an insured purchasing it.⁹⁸

This approach will present questions of fact regarding the probability of risk-shifting and the economic unity of the contract as a whole. It may not be susceptible to a bright line approach. This analysis does not provide a natural guideline for determining when, for example, a significant amount of risk shifting exists under a contract. Disagreements over the proper amount to be classified as significant will arise.

c. Business Purpose vs. Tax Avoidance

Some may see no need to go further in analyzing retros. But another concept from the tax law might offer a further glimmer of light even if it is a fairly aggressive anti-tax avoidance doctrine.

The tax law contains a further anti-tax avoidance doctrine, the business purpose requirement, which may be instructive on this issue. Without a purpose other than the tax avoidance, a transaction is not treated according to its form.⁹⁹ The author previously has argued that would-be insurance transactions (captive insurance arrangements in particular)¹⁰⁰ might be analyzed more aggressively for tax purposes by comparing the sufficiency of magnitude of the non-tax or business purpose of the transaction against its potential for tax avoidance.¹⁰¹

The commentators have often criticized the business purpose doctrine.¹⁰² Additionally, it has recently been described as obsolete in light of the availability of the economic reality and substance tests.¹⁰³ But the concept of business purpose can be helpful in framing the tax issue for retros.

⁹⁸ See Davis, *supra* note 14, at 38.

⁹⁹ See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.05 (5th ed. 1987).

¹⁰⁰ In that instance, the arrangements were captive insurance schemes.

¹⁰¹ See Winslow, *supra* note 9, at 134-37.

¹⁰² See Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355 (1963); Summers, *A Critique of the Business-Purpose Doctrine*, 41 OR. L. REV. 38 (1961); Note, *The Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability*, 49 FORDHAM L. REV. 1078 (1981). See also Winslow, *supra* note 9, at 115, 117 n.160.

¹⁰³ Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 678-83 (1989).

The business purpose doctrine provides a general framework for analyzing the insurance characterization of retro contracts. If the tax effect for the would-be insured in accelerating the tax deduction predominates over the business effect of securing insurance, then the deduction for the premium expense might be denied under that analysis.¹⁰⁴ In order to make some suggestions, it is necessary to explore both effects more fully.

The possible tax avoidance for the would-be insured in a retro contract lies in the acceleration of the deduction for the underlying liabilities. If there is no insurance, an accrual taxpayer could take a deduction for such liabilities after the "all events" test is satisfied and economic performance has occurred, which for workers' compensation and tort liabilities would occur only when the claimant is actually paid.¹⁰⁵ To avoid being put on that form of the cash method, a taxpayer may seek to use a cash flow program, such as a retro, in order to generate a current accrual deduction for premium expense. Because a present value deduction can be the economic equivalent of a future value deduction in a later year,¹⁰⁶ there might be no great harm in this if the earlier amount were properly discounted. Prior to the 1986 reforms directed at insurance company taxation, there might have been some doubt about whether the premium would have accurately reflected such a discount because the insurance company might have been willing to trade some of its special tax advantages under Subchapter L in inflating the current premium expense amount¹⁰⁷ and adjusting the payment terms to make the arrangement financially attractive to the insured. The 1986 Act largely removed the preferential tax treatment accorded insurers under Subchapter L, so any former abuse should also largely be gone.¹⁰⁸ Following that Act, insurance brokers have claimed that the former financial leeway evaporated as a result of the 1986 reforms and transactions largely should be based on the business economics. Thus, retro arrangements examined under this analysis should not cause great concern about abuse.

This background suggests that moderate amounts of insurance elements should suffice to sustain the form of the retro arrange-

¹⁰⁴ See Winslow, *supra* note 9, at 134-37.

¹⁰⁵ See I.R.C. § 461(a), (h); Treas. Reg. § 1.461-1(a)(2).

¹⁰⁶ See Bradley & Winslow, *supra* note 5; Jensen, *The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers*, 22 GA. L. REV. 229 (1988).

¹⁰⁷ See Winslow, *supra* note 9, at 89-92.

¹⁰⁸ See *id.* at 132-34.

ment. If there were still the possibility of substantial abuse, it might have been necessary to insist that the premium range be set to provide at least a twenty-five percent chance that the losses will be less than and exceed the amounts corresponding to the minimum or maximum premiums, respectively. Given that the large numbers of risks at issue mean aggregate losses can be predicted with good accuracy, these suggested constraints would impose a very narrow premium range of variability upon plans designed to generate premium expense deductions. The suggested constraints would mean that half or more of the time some element of insurance (risk distribution or risk shifting) would likely be borne out. In the situation since the 1986 Act, more moderate levels might be tolerated. If the minimum and maximum premiums are set such that there is at least a ten percent chance on either end that the losses will lie outside the range of premium variability (exclusive of the basic premium), then the concern discussed above should be satisfied.¹⁰⁹ This figure provides a realistic and significant chance that the insurer will cover unreimbursed losses, and reflects a substantial minimum premium that one would think would be unlikely to be paid in the absence of the coverage on the upper end.¹¹⁰ At that point one can conclude that there is the significant business effect in shifting substantial risk as a counter balance to the acceleration of the tax deduction.

d. Final Thoughts: The Service's Segregation of Contract Components

The Service's current campaign regarding retros is novel because of its dividing the contract into various elements. The Service's reasoning begins with the assertion that an "arrangement constitutes insurance *to the extent* that it provides for risk shifting and risk distribution."¹¹¹ This statement means that the part of an arrange-

¹⁰⁹ This does not mean that the probabilities must necessarily be equal on either end. It may be that insureds and insurers would not perceive this to be a dollar for dollar trade off at either end in order to achieve the suggested linkage and unification of the entire contract.

¹¹⁰ Although this is not an intended goal, this formula and suggested probabilities likely would result in the characterization of the vast majority of currently operative retro programs as "non-insurance." Insurers have been reluctant to accept significant risks at the upper end and insureds similarly have resisted significant minimum premiums. See Davis, *supra* note 14, at 38. This has meant that the limits are set with probabilities being infinitesimally small in almost all cases, with almost completely free variability.

¹¹¹ Tech. Adv. Mem. 86-38-003 (June 11, 1986); Tech. Adv. Mem. 86-37-003 (May 23, 1986).

ment containing these elements constitutes insurance. The remaining portion would not be insurance. This approach is both revolutionary and misguided.

The insurance tax authorities fail to support this approach. If risk shifting is present, the arrangement is insurance; if not, it is not insurance.¹¹² The *Le Gierse* Court examined the entire arrangement as a whole for its substance because the separate contracts in that case would not have been made independently.¹¹³ Retros should be examined similarly. Significant risk shifting present in a plan that is economically unified, as described above, should support an insurance characterization.¹¹⁴ That suggested approach is consistent with numerous theoretical insurance authorities that have regarded retros as insurance, despite premium variability.¹¹⁵ The Service's position simply ignores the theoretical literature not in accord with its views.

The Service's approach is the sort that will involve tax analysis of inappropriate questions. If a contract is not analyzed as a whole where appropriate and under the modern conceptions of insurance, then the tax law will be drawn into the minutiae of arrangements in an attempt to scrutinize and label each part as insurance or non-insurance. The current hair-splitting that proceeds unabated in the captive area should be sufficient incentive to caution against such a course.¹¹⁶

¹¹² See *Le Gierse*, 312 U.S. 531; *Treganowan*, 183 F.2d 288; Rev. Rul. 60-275, 1960-2 C.B. 43; Rev. Rul. 77-316; 1977-2 C.B. 53. In *Treganowan* the court concluded that the arrangement was insurance and made no mention of a separation of the contract into insurance and non-insurance components. *Le Gierse* stated the now often quoted test that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." *Le Gierse*, 312 U.S. at 539. The Court found that "the contracts [at issue] wholly fail[ed] to spell out any element of insurance risk." *Id.* at 541. All that was required was an element of risk-shifting and risk-distribution. The Service later recognized this when, in Rev. Rul. 60-275, it stated that, "an element of risk-shifting or [sic] risk-distributing is one of the requisites of a true insurance contract." 1960-2 C.B. at 45. Thus, these authorities do not treat an arrangement as insurance "to the extent" it shifts and distributes risk. Rather, insurance is either present in or absent from the arrangement depending on whether it contains these elements.

¹¹³ *Le Gierse*, 312 U.S. at 540.

¹¹⁴ There is some authority for segregating portions of a life insurance contract into term and other forms of life insurance. See *National Savings Life Ins. Co. v. Commissioner*, 84 T.C. 509, 545-49 (1985). The property/casualty insurance area apparently has not developed such authority. And in the life insurance area contrary authority would treat parts of a contract as inseparable if they would not be sold or purchased separately. See *Moseley v. Commissioner*, 72 T.C. 183, 187-88 (1979).

¹¹⁵ See *supra* notes 28-39 and accompanying text.

¹¹⁶ See authorities cited *supra* note 9.

One might claim that contrary to this criticism, the Service's position actually achieves a cleaner result. It might provide a reasonably clear line: the variable portion of the arrangement does not generate a premium expense deduction and the fixed portion does. But the Service's view on insurance may not be that simple, and if further statements by the Service are treated seriously and explored fully these complications appear. The Service stated that the variable premium beyond the minimum or basic premium could not under any circumstance be an insurance premium and hence would always be non-deductible. The Service also stated that the taxpayer may otherwise establish that amounts payable under the contract are "attributable to the insurance elements of the arrangement,"¹¹⁷ apparently referring to the nonvariable part of the amounts billed under the contract. Thus, it is not clear that those fixed amounts necessarily represent deductible insurance premiums.

In addition, other statements by the Service imply a further potential limitation on deductions for insurance premium expenses. The Service stated that due to the pooling process an insurer is able to accept each loss "for the group as a whole, so as to enable the insurer to accept each risk at a slight fraction of the possible liability upon it."¹¹⁸ This suggests that an insurance premium constitutes a small fraction of the amount of potential losses covered by the policy.

These suggestions greatly resemble an issue that has been posed in the captive area where large insureds also predominate.¹¹⁹ Some writers have interpreted the Tax Court's opinion in *Gulf Oil Corp. v. Commissioner*¹²⁰ to mean that a captive can insure its affiliates if it does more than half of its business outside its corporate group. This *Gulf Oil* dicta might be a bright line test for determining whether the captive arrangement is insurance.¹²¹ Some commentators have discounted that possibility for an insured with enough risks to achieve pooling among its risks alone, because the actual losses should not exceed by much those expected to occur.¹²² That

¹¹⁷ Tech. Adv. Mem. 86-38-003 (June 11, 1986).

¹¹⁸ Tech. Adv. Mem. 86-37-003 (May 23, 1986).

¹¹⁹ See Winslow, *supra* note 9, at 159-62.

¹²⁰ 89 T.C. 1010 (1987).

¹²¹ See Abramowitz & Allen, *Rev. Rul. 88-72 v. Gulf Oil—The Tax Court Should Reaffirm that Unrelated Risks Can Make a Difference*, 43 TAX NOTES 325, at 333 (1989); Bradley & Taten, *When Will Premiums Paid to Captive Insurers Be Deductible?*, 68 J. TAX'N 296, 298 (1988).

¹²² See Bradley & Taten, *supra* note 121, at 298 n.11.

interpretation would greatly limit the effect of the *Gulf Oil* language and would restrict the ability of a taxpayer with a great number of risks to insure with an affiliate.¹²³

This notion of insurance taken from the Service's Technical Advice Memoranda and other commentators focuses on a large difference between the premium charged and the potential losses. Insureds with negligible or small losses would allow for insureds with high losses by paying a premium in excess of such negligible or small losses. In the insurance company's collection of premiums, risk spreading or distributing occurs from insureds with high loss payments to those more fortunate insureds with loss payments less than expected. These views turn on a view that a large difference in the amount of losses exists among the numerous insureds. The majority of insureds would have fairly light loss payments and a small number would be visited with high losses. An insurance company covering a large group of insureds and thus bearing a vast aggregation of risks can predict its aggregate loss payment with far greater accuracy than anyone can predict the losses of any insured. An insurance company, thus, can set its premium at a level far below that of the losses visited upon the unluckiest insureds.

A sizeable insured utilizing a retro could not purchase insurance under these notions, if pursued to their logical extreme. These notions suggest that the bulk of the minimum premium that is subject to a reasonable lower limit cannot be paid for insurance. The business will certainly (in a statistical sense) be required to pay substantial sums as loss payments approaching the premium and, therefore, the losses covered are not the maturing of risks. Insurance covers only uncertain losses that can be called risks, not matters that are certain.¹²⁴ To the extent the minimum premium covers certain items it is not insurance.

The notion that a premium payment typically constitutes a "slight fraction of the risk"¹²⁵ is inappropriate to apply to large insurance contracts for reasons similar to those suggesting that risk distribution among insureds is no longer a necessary element of insurance.¹²⁶ Risk distribution among insureds was long ago necessary as a part of group coverage to adjust an individual insured's premium costs into line with the average loss. The presence of large

¹²³ See Winslow, *supra* note 9, at 159.

¹²⁴ See A. WILLETT, *supra* note 1, at 79 (insurance covers only uncertain losses).

¹²⁵ See *supra* note 118 and accompanying text.

¹²⁶ See Winslow, *supra* note 9, at 150-58.

numbers of insureds and the accompanying risk distribution reduced uncertainty. The grouping of insureds produced the numbers necessary to achieve some certainty for the benefit of all parties, a primary object of insurance. Some insureds paid more in premiums than they had losses and others experienced far greater losses than their premiums. Such collateral characteristics of insurance in the past should not determine the required elements of insurance today. Insurance transactions today can be much larger and the risks of any one insured might, as an aggregate, reach a size enabling a reasonable prediction of its losses. In addition, it has been observed by an insurance theorist that the concept of insurance does not require that the premium be a small portion of the amount of the risk, even if that is typically the relationship observed.¹²⁷ There are cases where the premium constitutes a sizeable part of the amount of the risk.¹²⁸

Analyzing large business insurance transactions to see whether the premium is a "slight fraction" of the covered risks will extend this challenge to insurance characterization beyond retro programs. Any large insured with a significant number of risks has similar vulnerability, including those purchasing policies where the premium is fixed and not subject to retrospective adjustment. This extension is possible because the simple view of insurance, with a premium typically being a small fraction of the risk covered, is not adapted to cases covering thousands of risks. For a large business, the bulk of losses are not really uncertain. For such an insured it will not be possible to have a premium equal to a slight fraction of the possible losses. If the notion that an insurance premium is a small fraction of possible losses is extended, then the bulk of a fixed premium policy would be non-insurance.¹²⁹

A contrary result given the adoption of such a notion is difficult to conceive but perhaps plausible. A large insured could be conceptualized as paying a premium apportioned among the multitude of covered risks. For example, a business insuring 25,000 automobiles could envision its premium as divided among the 25,000 units in comparing its situation to an individual insured, who as one of thousands of insureds, has insured a single automobile. For such a

¹²⁷ *Id.* at 161 n.329 (citing H. Denenberg, What Constitutes Insurance Within the Meaning of the Law (1965) (unpublished Ph.D. thesis)).

¹²⁸ *Id.* (Denenberg notes one example where the premium was sixty percent of the potential loss).

¹²⁹ *Cf. A. WILLETT, supra* note 1, at 79 (insurance covers only uncertain losses).

large insured, each part of the premium so apportioned would be a slight fraction of the corresponding potential loss. This type of analysis is artificial, stilted and should be unnecessary for the reasons discussed above but it at least provides a plausible way to reconcile this notion of a premium being a slight fraction of the covered risk with large insurance contracts.

The most sound approach would not make such fine distinctions regarding insurance and would not segregate the components of policies if the arrangement is economically whole. That is the purpose of the examination of the minimum premium amount. Once it is determined that the arrangement is economically a single transaction, the entire retro arrangement should be analyzed for significant risk shifting. If that is found in the level suggested above, the contract should be treated as insurance.¹³⁰

Finally, the Service's choice in focusing on retros from the insured's side is remarkable. Insurance with respect to insurers should include as much risk shifting as for the insureds. A full examination of insurance concepts logically should proceed with respect to companies in that business. A study of the nature of insurance would be much more likely revealing if industry practices were the subjects rather than isolated contracts of "insureds."

To be eligible for taxation under the principles of Subchapter L, insurers must demonstrate that they are predominantly in the

¹³⁰ There is an alternative definition of insurance in this context. This view represents a possibility, but one should hesitate to offer it as a primary choice for several reasons.

This view centers on the insured's obligation to pay a premium (albeit variable in sum) amount and the insurer's obligation to pay covered claims. This contrasts with the self-insurance situation where there is no current deduction because nothing is paid as the liability is not fixed and the amount is probably not determinable with reasonable accuracy. With a retro, the accrual of the liability to the insurer replaces the self-insured's uncertainty of its liability. It also consolidates the liabilities and ends the basic contest as to liability. With a limited range for premium adjustment it also can be argued that the amount can be determined with reasonable accuracy.

The principal issue would seem to be whether the type of contract described changes the liability from that which it would be without the arrangement with the insurer. One could argue, with some support in the theoretical literature, that the presence of the insurer as the source of indemnification merits an insurance characterization. See C. KULP, *supra* note 37, at 523; R. GOSHAY, *supra* note 3, at 42. But that conclusion seems overbroad. Even those who seem to state this test ultimately appear to rely on the presence of a maximum-minimum premium range for the conclusion. See C. KULP, *supra* note 37, at 519. Additionally, the case law, as described above, seems to be generally accepted as foreclosing this argument by finding that a retro arrangement without limits is not insurance even though claims against an insolvent business still could be paid by the insurer. See *Steere Tank Lines, Inc. v. United States*, 76-2 U.S.T.C. ¶ 9526 (N.D. Tex. 1976), *aff'd per curiam*, 577 F.2d 279 (5th Cir. 1978), *cert. denied*, 440 U.S. 946 (1979).

insurance business. A challenge on this point may make the Service's position less tenable when considering a entire insurance company. But this course has not been pursued, probably because a challenge of that sort has a lesser likelihood of success. Since retro plans constitute the predominant insurance for large businesses, a prominent insurer may not be in the insurance business under the Service's current notions of insurance. An attempt to recharacterize a significant portion of the insurance industry may not be acceptable and it may be similarly unlikely that the Service could succeed in recharacterizing even a significant portion of its business, even if no insurer will be found to be operating predominantly some other type of business.

CONCLUSION

There recently has been a tendency to overanalyze the term "insurance." This overly sensitive approach probably has resulted from the tax law historically placing too much importance on the characterization of a transaction as insurance for deduction purposes and perhaps for Subchapter L purposes. It is unwise for the term "insurance" to bear so great a load or for insurance to be treated much differently from other types of businesses.

A definition of insurance for federal tax purposes can draw reasonable lines based on current and well established theoretical literature that looks for reasonable amounts of risk shifting in the contract. Stilted interpretations should be avoided for the numerous difficulties that will follow. Analysis of insurance contracts such as retros should be in terms of economic substance and the other familiar tax doctrines, rather than an overly involved definitional approach. If properly followed, this approach will not permit taxpayer abuse. The clear abuses would be ended without causing the tax law to enter troublesome areas.

The insurance tax issues concerning retros as well as other insurance arrangements have already been handled in several ways. The retrospectively rated plans¹³¹ were once inordinately attractive to taxpayers because of their ability to trade on the entitlement of insurance companies to the Subchapter L benefits. The proper focus for changes was to these benefits and the 1986 Act significantly cut back on those advantages. If the tax treatment of insurance companies is relatively level compared to other businesses, that source

¹³¹ See Davis, *supra* note 14.

of abuse should not exist. If further adjustments along the line attempted in 1986 are needed, then attention should again be directed to Subchapter L.

Similarly, some of the plans described above involve deferred payments that can present an abuse, for example, if the premium amount is overstated and the interest element of the deferred payments is understated. This possibility should be controlled by directing attention to the time value of money, as was done by the 1984 Act and its numerous provisions imputing interest in a variety of contexts.¹³² Again, tinkering with the definition of insurance was not necessary to correct the abuse. Nor would it seem necessary to put all deferred premium payments on the cash method as has been done with the proposed regulations implementing the accrual accounting standard of economic performance.

A particularized focus on the source of the problem is much preferred. It goes to the root of the issue rather than treating the symptoms of the problem by ad hoc definitions of the term insurance or by broad brush treatment of insurance transactions as somehow different from other business transactions. If such an approach is followed and appreciated, it might be possible to avoid leaning so heavily on a definition of insurance, once the objectionable aspects of the transaction are removed.

The Government's continued fascination with insurance arrangements is unwarranted. There is no reason for all purchasers of insurance with a deferred premium arrangement where the payments are fixed according to a note to be required to account for that purchase on a cash basis. Nor should all retros be lumped together on the characterization of them as insurance. Rather, the tax law should attempt to sort the good from the bad under the guidelines described above.

¹³² See I.R.C. §§ 467, 1271-1275, 7872.